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No. 02-1272

In the Supreme Court of the United States

ROSEMARY DEPAOLI AND FRANK KRESOCK,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the district court erred in not instructing the jury that financial benefits received by an individual from a corporation do not constitute income until the amount of the benefits exceeds the amount owed by the corporation to the individual and that a corporation cannot generate dividend income in the absence of earnings and profits.

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OPINION BELOW

The opinion of the court of appeals (Pet. App. 1a-17a) is not published in the Federal Reporter, but is available at 41 Fed. Appx. 543.

JURISDICTION

The judgment of the court of appeals was entered on July 22, 2002. A petition for rehearing was denied on September 26, 2002. Pet. App. 1c-2c. On December 20, 2002, Justice Souter extended the time within which to file a petition for a writ of certiorari to and including February 24, 2003, and the petition was filed on that

date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Middle District of Pennsylvania, petitioners were each convicted on three counts of willfully attempting to evade income taxes, in violation of 26 U.S.C. 7201. DePaoli was also convicted on three counts of filing false corporate income tax returns, in violation of 26 U.S.C. 7206(1), and Kresock was convicted on three counts of aiding and assisting in the filing of false corporate income tax returns, in violation of 26 U.S.C. 7206(2). Gov't C.A. Br. 5-6. Kresock was sentenced to 20 months of imprisonment, to be followed by a three-year term of supervised release. DePaoli was sentenced to 16 months of imprisonment, to be followed by a three-year term of supervised release. Pet. App. 4a-5a. The court of appeals affirmed. *Id.* at 1a-17a.

1. Petitioners, husband and wife, are medical doctors who operated a medical practice through Columbia Medical Group, Inc. (CMG), a medical corporation they formed in 1988. Petitioners each owned one-half of the shares in CMG, and both acted as the corporation's employees, lessors, and creditors. They employed the certified public accounting firm of Herring & Roll to establish a system for compiling records in order to prepare and file individual and corporate income tax returns. Pursuant to the system, petitioners would send copies of CMG check stubs, bank statements, and payroll information to Herring & Roll on a monthly basis. Under the accounting system, petitioners were to add expense codes to the check stubs to enable

Herring & Roll to group and total the expenses at year end. Pet. App. 3a; Gov't C.A. Br. 6-8.

In 1995, a routine Internal Revenue Service (IRS) civil audit of CMG's 1993 corporate income tax return disclosed numerous suspicious deductions indicative of fraud. That led the IRS auditor to refer the case to the Criminal Investigation Division of the IRS. A criminal investigation revealed that, during the years 1992 through 1994, petitioners used CMG corporate checks to pay hundreds of thousands of dollars in personal expenses. Petitioners subsequently were indicted. Pet. App. 3a-4a; Gov't C.A. Br. 8-11.

The evidence at trial established that petitioners used CMG funds to purchase thousands of dollars worth of jewelry and guns, which were coded as "office supplies" on the check stubs provided to Herring & Roll. Petitioners also used CMG funds to purchase numerous vehicles, including a Ferrari Testarossa and Harley Davidson motorcycles. In addition, petitioners used corporate funds to renovate their vacation home, purchase gold coins, and pay for many personal items and services, including home furnishings, groceries, baby formula, diapers, child care, children's toys, a family cruise vacation, and maintenance expenses related to petitioners' homes. Petitioners also altered cash receipts that they submitted to CMG for reimbursement of business-related expenditures purportedly made on CMG's behalf. As a result, they improperly increased the business expense deduction on CMG's tax returns. Pet. App. 3a-4a; Gov't C.A. Br. 12-29.

On their individual income tax returns, petitioners did not report as income the CMG funds they used for personal expenditures. Instead, the expenses frequently were treated as business-related items that were deducted on CMG's corporate income tax returns.

Petitioners also failed to report as income on their personal tax returns fees they received for speaking engagements and for work they performed at a local hospital. Pet. App. 4a.

The evidence also established that petitioners took steps to conceal the personal nature of the corporation's expenditures by falsely coding the check stubs to make the expenses appear business related. For example, petitioner Kresock coded the purchase of several firearms as "yearly depreciable medical supplies" and coded the purchase of a Harley Davidson motorcycle as "equipment rental" for a cardiac echo machine. Gov't C.A. Br. 16; Pet. App. 4a.

2. In their proposed jury instruction, petitioners requested that the district court instruct the jury as follows:

> Whether a financial benefit received by an individual from a corporation such as Columbia Medical Group, Inc. is income that must be reported on that individual's personal income tax return depends upon the character of the benefit. If the benefit may have been repayment of a loan previously made by the shareholder to the corporation, it is not income to the shareholder and need not be reported on the shareholder's personal income tax return. In deciding whether the personal benefit which the government claims each defendant received as a result of the payment of personal expenses by Columbia Medical Group resulted in a substantial tax due, you must reduce the amount of the personal benefit received by the defendant by the amount the corporation owed that defendant.

C.A. App. 150. The district court declined to give the proposed instruction. Pet. App. 10a.

3. On appeal, petitioners argued, *inter alia*, that the district court erred in refusing to instruct the jury that corporate expenditures for the benefit of shareholders are not personal income unless the expenditures exceed all outstanding shareholder loans to the corporation and that a corporation cannot generate dividend income in the absence of earnings and profits. Pet. App. 10a. In support of that argument, petitioners principally relied on the Second Circuit's opinion in *United States* v. *D'Agostino*, 145 F.3d 69 (1998). The court of appeals rejected petitioners' claim, ruling that the district court had not erred in declining to give petitioners' requested jury instruction. Pet. App. 10a-13a.

The court explained that the Second Circuit's approach in *D'Agostino* "does not state the prevailing rule," and that its own decisions and those of a number of other courts of appeals reject the analysis in *D'Agostino*. Pet. App. 11a-12a. The court also emphasized that, unlike in *D'Agostino*, where the government had conceded that the defendant's corporation had no earnings or profits, "[h]ere, there was evidence supporting a conclusion that, when adjustments were made for personal items falsely labeled as business expenses, CMG showed a profit for each year charged in the indictment." *Id.* at 12a. Finally, the court observed that, whereas petitioners argued that the diverted funds could have been lawfully accounted for as a return of capital or repayment of a loan and that the company would have had little or no taxable income if it had treated the diverted funds as expenses through the issuance of 1099 forms, "there was no evidence from which it could be inferred that the diverted income was accounted for in this way." *Id.* at 12a-13a.

ARGUMENT

Petitioners renew their contention (Pet. 12-23) that the district court erred in declining to instruct the jury on their defense theory that a corporation cannot generate dividend income if it has no earnings and profits and that, in that event, funds paid to a shareholder should be treated as a nontaxable repayment of a loan or return of capital instead of dividend income as long as the payments do not exceed the amounts owed to (or invested by) the shareholder. Petitioners argue that the court of appeals' decision, in upholding the district court's refusal to give their requested jury instruction, conflicts with the Second Circuit's decision in *D'Agostino*, 145 F.3d at 69. Petitioners' argument lacks merit and does not warrant review.

The Second Circuit held in *D'Agostino* that, in a tax evasion case, corporate funds distributed to a shareholder constitute taxable income as a constructive dividend only to the extent that the corporation had earnings and profits for the tax year. 145 F.3d at 72-73. In the absence of earnings and profits, the court ruled, the distribution should be treated as a nontaxable return of capital or, if applicable, repayment of a loan. *Id.* at 72; see *United States* v. *Bok*, 156 F.3d 157, 162 (2d Cir. 1998). The Second Circuit's view fails to account for the fact that, under the Internal Revenue Code, the distribution of funds to a shareholder constitutes a dividend not only when the payment comes from the corporation's "earnings and profits of the taxable year," 26 U.S.C. 316(a)(2); see *Bok*, 156 F.3d at 162, but also if the funds come from "earnings and profits accumulated" over previous years, 26 U.S.C. 316(a)(1). In addition, whereas the Second Circuit has indicated that it is irrelevant whether the taxpayer and corporation intend

for the distribution to constitute a return of capital or loan repayment rather than a dividend or account for the distribution as such, see *Bok*, 156 F.3d at 162-163; *D'Agostino*, 145 F.3d at 72-73, it is well settled that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-149 (1974).

In any event, even under the Second Circuit's approach, petitioners' requested jury instruction was correctly denied. A requested theory-of-defense instruction must correctly state the law and have a sufficient evidentiary foundation in the record. See, *e.g.*, *Mathews* v. *United States*, 485 U.S. 58, 63 (1988); *United States* v. *Johnson*, 278 F.3d 749, 752 (8th Cir.), cert. denied, 536 U.S. 949 (2002); *Bok*, 156 F.3d at 163. Petitioners' requested instruction fails on both counts.

First, as to whether the instruction correctly stated the law in the Second Circuit, a distribution by a corporation to a shareholder may be treated as a return of capital or repayment of a loan under *D'Agostino* only if the corporation lacked earnings and profits for the tax year in question. 145 F.3d at 72; see *Bok*, 156 F.3d at 162 ("A central condition for the application of the return of capital theory * * * is that the corporation must not have earned a profit for the year in which the withdrawal was made."). Petitioners' proposed instruction, however, failed to condition the reduction of "the amount of the personal benefit received by the defendant by the amount the corporation owed that defendant" (C.A. App. 150) on the absence of corporate earn-

ings and profits. In fact, the requested instruction makes no mention of CMG's earnings and profits.

In addition, there was an inadequate factual basis in the record for petitioners' requested instruction. The Second Circuit requires the defendant to produce evidence showing the absence of corporate earnings and profits. *Bok*, 156 F.3d at 163-164. As the court of appeals observed in its opinion, in *D'Agostino*, unlike this case, it was undisputed that the corporation lacked earnings and profits. Pet. App. 12a. Petitioners argue (Pet. 17) that there was evidence from which the jury could have concluded that CMG lacked earnings and profits, citing two transcript pages (11/19/99 Tr. 112-113) from the direct testimony of a defense accounting expert. The witness, however, did not testify that CMG lacked earnings and profits for the relevant tax years. Instead, he testified hypothetically that, "If [CMG] had issued 1099s, the 1099 would have been deductible by the corporation, assuming the deductions were proper, and the 1099 issuance would have created the expenses which would then result in the corporation having no taxable income or very little taxable income." 11/19/99 Tr. 113. As the court of appeals explained, "there was no evidence from which it could be inferred that the diverted income was accounted for in this way." Pet. App. 12a-13a. The expert's testimony thus does not assist petitioners.

Moreover, the distributions to petitioners could not in fact have been deducted by the corporation for purposes of determining whether they constituted dividend income to petitioners. The Second Circuit's decisions rely on the provisions in the Internal Revenue Code defining corporate distributions and dividends, see *Bok*, 156 F.3d at 162; *D'Agostino*, 145 F.3d at 72, and under those provisions, a distribution constitutes a

dividend if it comes from the corporation's earnings and profits for the tax year, "computed as of the close of the taxable year *without diminution by reason of any distributions made during the taxable year.*" 26 U.S.C. 316(a)(2) (emphasis added). Therefore, even under the Second Circuit's approach, the court of appeals correctly rejected petitioners' assertion that the district court should have instructed the jury on their defense theory. See *Bok*, 156 F.3d at 163-164 (instruction on return of capital theory not required, because defendant failed to satisfy his burden of producing evidence of absence of corporate earnings and profits); see also *United States* v. *Leonard*, 524 F.2d 1076, 1083-1084 (2d Cir. 1975), cert. denied, 425 U.S. 958 (1976).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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